

# Nuances of purchasing a medical practice

Although similar to acquisitions in other industries, there are many nuances unique to the purchase of a medical practice. Here are a few to consider.

**By Peter A. Greenbaum**

There are two common ways medical practices are bought and sold: through the normal "lifecycle" of the practice or to an unaffiliated third party. Due to today's regulatory minefield in healthcare, most practices are not really sold at all. Rather, the normal lifecycle of a medical practice takes its course. A young physician is employed as an associate, moves through the ranks and is admitted as a partner after completing his or her partnership track, continues through to the senior-owner rank and then retires, thereafter having the younger generation of associates and partners buy his or her interest through a deferred compensation and/or buyout package.

That said, practices still are purchased outright by unaffiliated third parties. The process is essentially identical to that of the purchase of a business in other industries. A purchaser identifies a practice it desires; the seller and purchaser negotiate terms of the transaction and then consummate the transaction pursuant to one or more definitive agreements. These may include a purchase agreement, employment agreement and other transaction documents. In addition, a purchaser may obtain third-party financing if necessary. Although similar to acquisitions in other industries, there are many nuances unique to the purchase of a medical practice that should be considered.

Many states, including New Jersey, prohibit what is generally referred to as the "corporate practice of medicine." The doctrine specifies that medical services must be provided through individuals licensed to practice medicine here, whether directly or indirectly through a professional corporation in which all owners are so licensed. In other words, non-licensed individuals generally cannot own medical practices. The rationale for the doctrine is that the public is best-served when physicians are in control, presumably making decisions in the best interest of patient care rather than when unlicensed individuals



and corporations are in control, making decisions to serve the bottom line. Thus, before beginning the acquisition process, the purchaser should confirm that all members of the purchasing group are duly licensed physicians in New Jersey.

## Benefits? Assets vs. stock

Transactions that are structured as the acquisition of assets, rather than stock, generally provide the purchaser with two benefits. First, the acquisition of assets reduces the risk that liabilities will be assumed by the purchasing entity. By contrast, all liabilities are effectively assumed if the transaction is structured as a stock purchase. Second, the purchaser is able to allocate the purchase price among the purchased assets, which in turn will be depreciated and provide an income-tax deduction for the purchaser. If the latter is the structure of the acquisition, the acquired assets must be clearly identified. In particular, the purchaser must specify that he or she is acquiring the physician medical records, practice trade name and telephone numbers. The records are needed for the continuity of patient care and in order to notify patients of the "new practice." In addition to the physicians and office location, the real value of many practices is the trade name and telephone number. Indeed, many patients identify with the phone number or trade name of a practice, and often little else.

As noted, one of the most significant "assets" are the physicians themselves. Often, patients will follow a particular physician without regard to location, especially with certain specialties. Thus, it is imperative that a purchaser obtain, as part of the closing, an employment agreement from each employed physician at the practice to ensure the transition of the practice to the purchaser and to maintain the continuity of patient care. The

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## Lifecycle of a medical practice: A young physician moves through the ranks until reaching senior owner. When he retires, the younger generation of associates and partners buy his or her interest.

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employment agreements also must contain a restrictive covenant that prohibits each physician from practicing medicine during the term of employment other than through the purchaser, and for a specified period after the termination of employment within a certain geographic area, as well as prohibits the employed physician from soliciting patients, referral sources and employees. The physician should also resign his or her privileges at all hospitals within the restricted period as well. Such restrictive covenants must be obtained not only from the selling physicians but the employed physicians as well.

## Beware the pillaging

Without such restrictions, the physicians may leave the practice, open a new practice in the vicinity of the purchaser's location, solicit patients, and/or pillage employees, thus reducing the value of the practice just acquired — in some cases even rendering it worthless.

A significant asset is the actual office location. Just as a patient may identify only with a physician, and "follow the physician," often a patient is concerned only that the locale be in close proximity to his or her home or office. Thus, it is imperative that the purchaser assume the seller's office lease or enter into a new office lease

that adequately governs the use and occupancy of the office location. An exhaustive commentary on a lease negotiation is beyond the scope of this article, however, there are certain provisions generally of paramount importance to physician groups. First, it may be appropriate to request an exclusive for the physician's specialty, especially if the landlord owns many buildings in the immediate vicinity or the building is a medical arts building. In addition, it is not unusual for medical groups to have extra space in their suite and to sublease such extra space to other physicians. Almost all leases prohibit the subletting of space without the landlord's consent. With this in mind, it is a good idea to include a provision in the lease that gives the medical group, as tenant, the right without landlord's consent to sublease up to a specified number of square feet or the entire office on specified days.

## Market, market, market!

As with all acquisitions, a good marketing campaign is useful just before or immediately after consummation of the transaction. In the context of medical practices, notices sent to current and former patients are at the core of any such marketing campaign. The notice should include reassuring descriptions of the purchaser's medical ability and similar medical philosophies and reaffirmation of medical care. New Jersey does not require formal notification in the context of the sale of a practice (although there are regulations relating to the continuity of patient care). However, a purchaser will want the seller to be involved with the notification and marketing process. Depending on the number of patient notifications to be sent (which is dependent on the size of the practice and the number of previous years to be covered), the cost of the

notification could be excessive and thus an allocation of the cost between the seller and purchaser should be considered. In addition, in-person introductions to patients leading up to and possibly after the closing often are part of the transition process.

It is not unusual for the closing of a sale transaction to be subject to the satisfaction of certain pre-closing contingencies. In fact, we have already identified common ones above, such as employment agreements and leases. Unique to the medical industry is the ability to bill government payors (Medicare and Medicaid) and private third-party payors for medical services performed. Before receiving remuneration for medical services performed, a practice and its physicians must obtain the approval of each third-party payor in which they are a participating provider - i.e. credentialing. The credentialing process can take a matter of days in the case of some private payors, to weeks or months in the case of government payors. Thus, the purchaser should consider requiring these approvals as a pre-closing contingency. Often the practice will hold its billing until it has received the applicable third-party approval, which may invariably lead to a cash-flow problem.

## Borrow receivables or finance?

In the context of the acquisition of a medical practice, the cash-flow issue often is addressed in two ways by the purchaser — by the borrowing or outright purchase of the seller's accounts receivable and/or obtaining third-party financing. Each scenario raises many concerns which must be addressed. First, in the case of accounts receivable, representations must be given regarding collectability, and a post-closing adjustment of the purchase price may be appropriate for deficient collections.

Also, if the purchaser is merely borrowing the seller's accounts receivable (and therefore are collected with an obligation to repay at some later date), it may be appropriate that the purchaser charge the seller a billing-and-collection fee and conversely the seller charge the purchaser interest on such amounts. Further, as a patient may owe the seller for pre-closing services as well as the purchaser for post-closing services, a method of allocation of collected amounts should be included. Second, if third-party financing is to be used as working capital, often the purchaser's accounts receivable form the "borrowing base" of the loan. The purchaser must ensure that both billed and unbilled accounts are included in the borrowing base and that the lender has

not imposed too many exclusions.

Finally, malpractice insurance has become a significant issue in New Jersey due to the rise of premiums. This has affected almost every medical specialty. It is imperative that the purchaser carefully scrutinize the seller's malpractice premiums, especially if the purchaser is acquiring the ownership interest of the selling physicians (rather than the assets). Malpractice insurance generally is characterized as occurrence-based, which will cover a claim against a physician if the underlying action to the claim occurred during the policy period (even if the claim was asserted after the policy expired), or claims-made, which will cover a claim against a physician only if the policy is in effect at the time

the claim is asserted (which can be effectively converted into an occurrence policy by the acquisition of a "tail/prior acts" liability insurance policy). In many specialties it is fiscally difficult, if not impossible, to obtain an occurrence-based policy. Regardless, all policies must be reviewed for existing and former employees to ensure the purchaser is not assuming (directly or indirectly) any malpractice claims.

## Conclusion

It is essential that a purchaser of a medical practice consult with professionals experienced in the healthcare industry — whether attorney, accountant or other professional consultant — as the engagement of skilled professionals can help ensure a smoother transition with less unexpected consequences. ☉



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